SECONDARY MARKET ACTIVITY

(Dollars in millions)

YEAR AND MONTH	FNMA Portfolio Comm.	FNMA Portfolio Purc.	FNMA Mortgage-Backed Securities Outstanding	FNMA Mortgage-Backed Securities Issued	FHLMC* Comm. to Sell	FHLMC* Comm. to Buy	FHLMC* Mtg. Purc.	FHLMC* Mtg. Sold	GNMA Pass-Through Securities Applications	GNMA Pass-Through Securities Issued
1986										
JUL	$3,270	$3,343	$76,197	$6,106	$8,585	$7,863	$8,518	$8,118	$14,246	$10,226
AUG	3,840	3,800	81,060	7,079	12,722	13,707	10,458	10,127	10,177	6,813
SEP	4,248	4,649	86,359	7,357	10,943	10,658	12,485	13,090	36,333	12,861
OCT	2,375	3,784	89,573	5,535	11,595	9,356	11,566	11,401	9,859	10,221
NOV	1,811	2,549	93,525	5,636	n.a.	n.a.	n.a.	n.a.	13,319	9,612
1986 TOTAL	32,987	30,826	—	60,566	n.a.	n.a.	n.a.	n.a.	152,911	98,169
1985 TOTAL	20,225	19,848	—	23,649	44,085	46,762	44,012	44,085	64,360	45,868
12 MONTHS										
1986	32,987	30,826	—	60,566	89,264	90,880	82,306	80,312	152,911	98,169
1985	20,225	21,510	—	23,649	35,615	38,483	34,236	31,671	64,360	45,868
1984	21,006	16,721	—	13,546	22,669	24,269	15,505	14,158	36,101	27,857
1983	18,607	17,553	—	13,340	28,064	29,050	19,929	19,117	70,280	50,496

* FHLMC Year-to-date totals are for 10 months only.

INTEREST RATES AND YIELDS

YEAR AND MONTH	1- to 4-UNIT MORTGAGES: FHA OPINION SURVEY FHA New[4]	FHA OPINION SURVEY CONVENTIONAL New	FHA OPINION SURVEY CONVENTIONAL Existing	FHLBB SURVEY CONVENTIONAL New	FHLBB SURVEY CONVENTIONAL Existing	FNMA 1 Yr. ARM (1%/Yr.)	FNMA FRM Conv.	APARTMENTS[5]
1986								
AUG	9.80%	9.88%	9.92%	10.26%	10.26%	7.96%	9.455%	11.45%
SEP	9.90	9.96	9.95	10.17	10.08	7.86	9.588	12.16
OCT	9.80	9.89	9.85	10.02	9.97	7.75	9.425	12.09
NOV	9.26	9.47	9.47	9.91	9.84	7.76	9.440	11.54
DEC	9.21	9.33	9.36	9.69	9.65	7.94	8.973	11.09
1987								

YEAR AND MONTH	CURRENT SECONDARY MARKET YIELDS GNMA[6]	FNMA[6]	FHLMC[6]	SELECTED SECURITIES A-Rated[7] Utility	U.S. Government 10-yr.	U.S. Government 26-wk.	Prime Comm. Paper 90-119 Days
1986							
AUG	9.11%	9.20%	9.23%	9.51%	7.17%	5.55%	5.92%
SEP	9.28	9.25	9.30	9.56	7.45	5.35	5.68
OCT	9.05	9.12	9.16	9.48	7.43	5.26	5.68
NOV	8.78	8.91	8.94	9.31	7.25	5.42	5.76
DEC	8.40	8.48	8.50	9.08	7.11	5.53	6.10
1987							

SPREADS (Basis Points)

YEAR AND MONTH	FHA New Minus A-Utility	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
1986				
AUG	29	194	203	206
SEP	34	183	180	185
OCT	49	162	169	173
NOV	18	153	166	169
DEC	29	129	137	139
1987				

NA—Not available. p—Preliminary.

[1] From the National Association of Realtors "Existing Home Sales" series.

[2] Mutual Savings Banks and Commercial Banks.

[3] FHA applications received includes the Direct Endorsement Program starting in 1984.

[4] Secondary market gross yields.

[5] Federal Home Loan Mortgage Corp. Existing Construction only.

[6] Securities for 0 to 30 day delivery.

[7] Prior to January 1984 this rate was for Aaa-rated New Issue Utility Bonds.

[8] Year-to-date seasonally adjusted series not calculated.

[9] 1985 data on mortgage bankers obtained from the HUD Survey of Mortgage Lending Activity.

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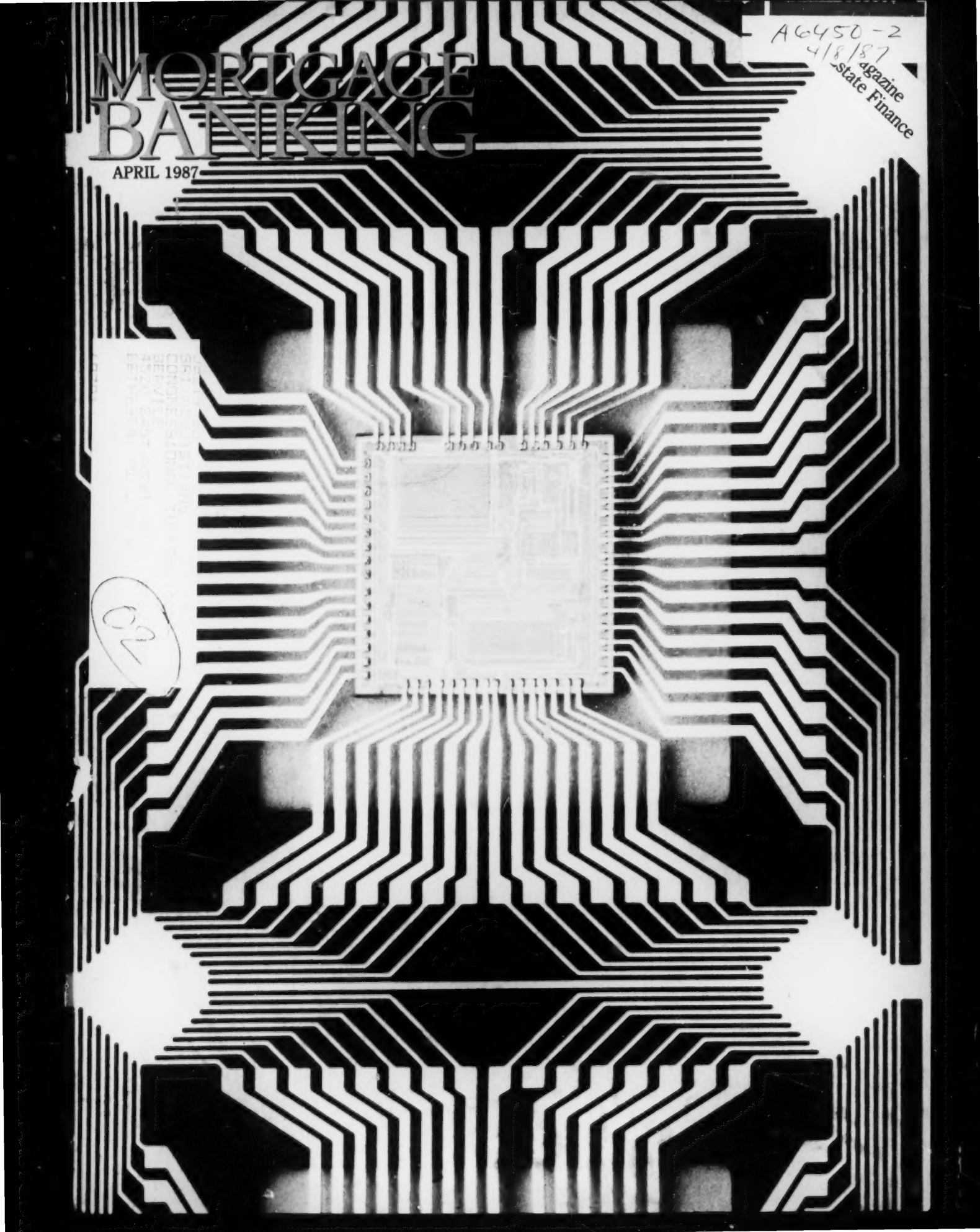

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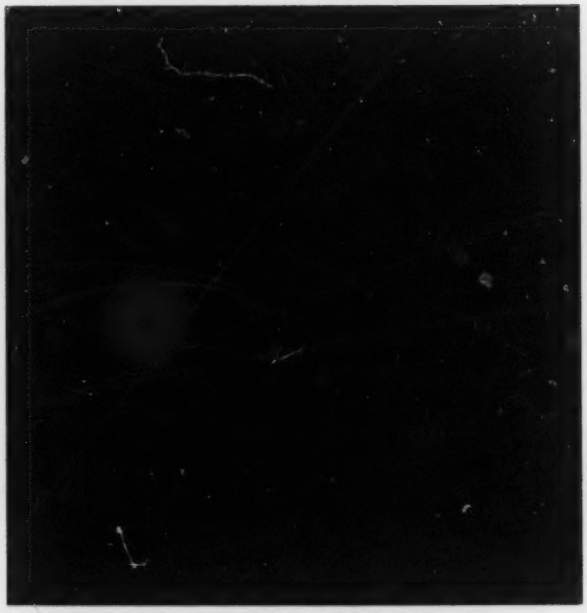

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Richard W. Peach, Ph.D

A PERMANENT DECLINE IN HOMEOWNERSHIP?

The Tax Reform Act of 1986 represents a radical change in tax law that will certainly have significant effects on the economy. One sector of the economy that will be particularly affected by this legislation is housing, both owner-occupied and rental. While much has been made of the fact that mortgage interest and property taxes will remain deductible for homeowners, the value of those deductions will be significantly reduced, causing the after-tax cost of homeownership for both current and prospective homeowners to increase relative to the costs of other goods and services that households consume. At the same time, the lengthening of depreciation periods, the repeal of the capital gains exclusion and numerous other changes in tax law will make rental housing a much less attractive investment, thereby reducing construction of new rental housing which in time will cause rents to increase faster than they would have otherwise.[1]

On balance, these effects of tax reform are unlikely to cause a permanent decline in the homeownership rate. In fact, it is possible that the increase in rents will induce an increase in the proportion of homes that are owner-occupied, particularly for lower- and moderate-income households. At the same time, however, the increase in the cost of housing, whether owner-occupied or renter-occupied, is likely to cause a decline in the quantity of housing that households demand. This decline in demand is likely to reduce the value of the existing housing stock and reduce the amount of future investment in new housing.

The cost of homeownership When people purchase housing they must make two decisions: how much housing they want and whether they are going to buy or rent. The cost of owning one's home includes mortgage interest; property taxes; depreciation of the structure; and maintenance, insurance and utilities. Another important cost is the interest income that could be earned if the money used for a down payment and closing costs had been invested in some other asset. Mortgage interest and property taxes are deductible, while the implicit net income realized from the equity in the home is not taxed. Thus, homeownership typically results in tax savings for the homeowner, which

"One sector of the economy that will be particularly affected by this legislation is housing, both owner-occupied and rental."

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makes the after-tax cost of homeownership significantly less than the before-tax cost. The after-tax cost of homeownership is the true cost and thus influences the quantity of housing demanded and so the value the market places on a given property. The cost of homeownership relative to the cost of renting comparable housing influences the tenure choice decision.

Overview of the Tax Reform Act of 1986

Table 1 provides a side-by-side comparison of the provisions of the previous tax law that determine an individual's federal tax liability and the after-tax cost of owner-occupied homes with those same provisions under the Tax Reform Act of 1986. With regard to the after-tax cost of homeownership, the relevant features of the new tax law are (1) a reduction of marginal tax rates, (2) an increase in the zero bracket amount (ZBA) or standard deduction, (3) an increase in the personal exemption, and (4) the limitation or repeal of previously allowed non-homeownership deductions.

The combined effect of these changes is to raise the after-tax cost of owner-occupied homes by reducing the value of homeownership itemized deductions. The reduction in marginal tax rates directly reduces the value of all itemized deductions so that a given dollar amount of deductions results in a reduced amount of tax savings. For

TABLE 1

Comparison of Individual Income Tax Provisions Under 1986 Tax Law and the Tax Reform Act of 1986

	1986 Tax Law	Tax Reform Act of 1986
PERSONAL MARGINAL TAX RATES	14 rate brackets from 11% to 50%	2 rate brackets: 15%, 28%[a]
EXEMPTIONS		
Self, spouse	$1,080	$2,000[b,c]
Dependents	$1,080	$2,000[b,c]
Elderly	$1,080	Repealed
Blind	$1,080	Repealed
ZERO BRACKET AMOUNTS or Standard Deductions		
Single	$2,480	$3,000[d]
Joint	$3,670	$5,000[d]
Head of Household	$2,480	$4,400[d]
INDEXED RATE BRACKETS, EXEMPTIONS AND ZBA	Yes	Yes, beginning in 1989
PERSONAL DEDUCTIONS		
Mortgage Interest		
Principal Residence	Deductible	Deductible on mortgage debt up to 100 percent of original purchase price plus improvements[e]
Secondary Residence	Deductible	Deductible for one secondary residence on mortgage debt up to 100 percent of original purchase price plus improvements[e]
Other Personal Interest	Deductible Investment interest limited to $10,000 plus investment income	Nondeductible Investment interest limited to investment income. Four-year phase out[f] (Expanded definition of interest subject to limit)[g,h]
Real Property Taxes	Deductible	Deductible
Personal Property Taxes	Deductible	Deductible
State and Local Income Taxes	Deductible	Deductible
State and Local Sales Taxes	Deductible	Non-deductible
Medical Expenses	Deductible, above 5% of AGI	Deductible, above 7.5% of AGI
Charitable Contributions	Deductible for itemizers and for non-itemizers (non-itemizers deduction expires after 1986)	Deductible for itemizers but not for non-itemizers
Miscellaneous Deductions	Yes, for itemizers only	Yes, above 2% of AGI for itemizers only
Two-Earner Deduction	Yes, 10 percent of lower salary	Repealed
Child Care Credit	Credit from 20% to 30% on expenses up to $2,400 per child	Same as 1986 tax law

example, where $1 of itemized deductions results in $0.25 of tax savings with a 25 percent marginal tax rate, tax savings are reduced to $0.15 with a 15 percent marginal tax rate. Increasing the ZBA or standard deduction also reduces the value of a given dollar amount of itemized deductions because it is the amount of such deductions above the ZBA which reduces taxable income. Increasing the value of the personal exemption tends to reduce the value of itemized deductions because for a given level of gross income, a larger personal exemption results in a lower taxable income. Thus, it is likely to result in a lower marginal tax rate. Finally, the limitation or repeal of non-homeownership deductions tends to reduce the value of homeownership deductions by reducing the total dollar amount of itemized deductions in excess of the standard deduction.

A simplified example

Consider the following simplified example, frequently used in residential sales presentations, of the determination of the after-tax cost of homeownership. As presented in Table 2, assume that a taxpayer recently purchased a $100,000 home with a 20 percent down payment and an $80,000 mortgage with a fixed interest rate of 10 percent and a 30-year term. Property taxes are assumed to be 1.23 percent of the home value, the nationwide average for single-family homes.[2] The before-tax cost of owning this home would be $9,230 ($8,000 of mortgage interest and $1,230 of property taxes). Based on industry-wide underwriting criteria, a minimum income of $30,100 would be required to qualify for this mortgage. It is further assumed that this taxpayer files a joint return with four exemptions. On average, this taxpayer is likely to have non-housing itemized deductions (i.e., state and local taxes, non-mortgage interest, etc.) roughly equal to the 1986 tax law standard deduction or ZBA of $3,670 (about 12.2 percent of gross income). Therefore, under the old law, the full amount of homeownership deductions of mortgage interest and

	1986 Tax Law	Tax Reform Act of 1986
FRINGE BENEFITS		
Health Insurance	Not taxed	Same as 1986 tax law
Group-Term Life Insurance Premiums	Premiums for insurance more than $50,000 taxed	Same as 1986 tax law
Dependent Care Assistance	Not taxed	Same as 1986 tax law
RETIREMENT SAVINGS		
IRA limit Spousal IRA	$2,000 $250	Repealed for individuals who are active participants in an employer-sponsored retirement plan with AGI (before IRA deduction) in excess of $50,000 (joint return) or $35,000 (single return). Non-deductible contributions can be made up to $2,000 ($250 for spousal contribution) with continued deferral of tax on earnings
401(k) plans	Annual maximum combined employee/employer contributions the lesser of $30,000 or 25% of non-deferred compensation	$7,000 annual maximum for employee, the lesser of $25,000 or 25% of compensation maximum combined employee/employer
OTHER INDIVIDUAL ITEMS		
Rollover of Capital Gains on Principal Residence	Capital gain tax deferred if seller purchases another residence costing at least as much as the one sold within two years	Same as 1986 tax law
One-time Exclusion on Capital Gains on Principal Residence	One-time exclusion of gains up to $125,000 on sale of principal residence for taxpayers 55 or older	Same as 1986 tax law
Income Averaging	Yes	Repealed
MUNICIPAL BONDS		
Mortgage Revenue Bonds (MRBs)	Tax-exempt with volume restrictions; authority to issue expires December 31, 1987	Tax-exempt, with greater targeting toward lower income individuals and more restrictive volume limitations; sunset date extended to December 31, 1988

[a] Individual tax rates in 1988 for a joint return are:

Taxable Income	Rate
$0–$29,750	15%
$29,751 and over	28%

The benefit of the 15 percent marginal rate is phased out by a 5 percent surtax for higher income taxpayers with taxable income between $71,900 and $149,250 (joint returns) or between $43,150 and $89,560 (single return). Thus, the effective marginal tax rate in these ranges is 33 percent.

[b] The personal exemption is increased to $1,900 in 1987, $1,950 in 1988, and $2,000 in 1989.

[c] Beginning in 1988, the personal exemption would be phased out by a 5 percent surtax on the amount of taxable income in excess of $149,250 for joint returns until the benefit of the personal exemption is exhausted. The phase-out range extends for $11,200 of taxable income for each exemption claimed, over which the effective marginal rate remains at 33 percent.

[d] These amounts are raised by $600 for elderly and for blind taxpayers.

[e] Interest on mortgage debt exceeding 100 percent of original purchase price plus improvements would be deductible if incurred to meet education or medical expenses.

[f] Under the phase-out, the percentage of personal interest deductions disallowed are as follows: 1987, 35 percent; 1988, 60 percent; 1989, 80 percent; 1990, 90 percent; 1991, 100 percent.

[g] Included in the definition of interest subject to limitation is the taxpayer's share of all interest expense of S corporations in which the taxpayer is not actively engaged in management and the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. The proposal would also include as investment interest the taxpayer's share of the interest expense of certain trusts and other entities in which he is a limited entrepreneur.

[h] Interest from any activity subject to the passive loss limitation will not be treated as investment interest.

TABLE 2

Simplified Example of the Impact of Tax Reform on Annual After-tax Homeownership Costs

	1986 Tax Law	Tax Reform Act of 1986
Before-tax Homeownership Costs		
Mortgage interest	$ 8,000	$ 8,000
Property taxes	1,230	1,230
Total	$ 9,230	$ 9,230
Itemized Deductions		
Homeownership Deductions		
Mortgage interest	$ 8,000	$ 8,000
Property taxes	1,230	1,230
Non-homeownership Deductions	3,670	2,000
Subtotal	$12,900	$11,230
Less: ZBA or Standard Deduction	$ 3,670	$ 5,000
Total Itemized Deductions	$ 9,230	$ 6,230
Homeownership Tax Savings	9,230 × 0.25 = 2,308	6,230 × 0.15 = 935
After-Tax Homeownership Cost	$ 6,922	$ 8,295
Change: $	—	+$ 1,373
%	—	+19.8%

TABLE 3

Impact of the Tax Reform Act of 1986 on Annual After-tax Homeownership Costs

Home Price	Corresponding Income	Annual After-Tax Cost: 1986 Tax Law	Annual After-Tax Cost: Tax Reform Act of 1986	Change: $	Change: %
$ 50,000	$ 15,000	$ 4,683	$ 5,045	$ 362	7.7%
75,000	22,600	6,705	7,299	594	8.9
100,000	30,100	8,515	9,492	977	11.5
150,000	45,200	11,576	13,228	1,652	14.3
200,000	60,200	14,308	15,506	1,198	8.4
300,000	90,300	19,166	22,578	3,412	17.8
500,000	150,440	30,455	35,717	5,262	17.3

property taxes would be evaluated at a 25 percent marginal tax rate. With itemized deductions in excess of the ZBA of $9,230, these deductions result in $2,308 of tax savings, which bring the after-tax cost of owning this home down to $6,922.[3]

Under tax reform the after-tax cost of owning this home will rise significantly due to the impact of three changes:

- Lower marginal tax rates;
- A higher ZBA or standard deduction;
- Repeal or limitation of many non-housing itemized deductions.

Referring again to Table 2, under the Tax Reform Act of 1986, the non-homeownership itemized deductions decrease to about $2,000 for this taxpayer while the standard deduction is increased to $5,000. The net impact of these changes is to reduce the dollar amount of homeownership deductions that will provide tax savings by $3,000, from $9,230 to $6,230. In addition, that reduced amount of allowed homeownership deductions is evaluated at a 15 percent marginal rate. The bottom line is that the homeownership tax savings have declined from $2,308 to $935, thereby boosting the after-tax homeownership cost by $1,373 or 19.8 percent.

More detailed estimates

Table 3 provides more detailed estimates of the increase in after-tax homeownership costs resulting from tax reform for seven representative home prices. Included in these estimates are the tax considerations of the funds used for the down payment, the income from which goes untaxed for

TABLE 4

Impact of the Tax Reform Act of 1986 on Federal Tax Liabilities[a]

Home Price	Corresponding Income	Tax Liability of Homeowners: 1986 Tax Law	Tax Liability of Homeowners: Tax Reform Act of '86	Change: $	Change: %	Tax Liability of Renters: 1986 Tax Law	Tax Liability of Renters: Tax Reform Act of '86	Change: $	Change: %
$ 50,000	$ 15,000	$ 336	$ −1	$ −337	−100%	$ 966	$ 335	$ −631	−65.3%
75,000	22,600	984	992	+8	+0.8	2,250	1,658	−592	−26.3
100,000	30,100	1,762	1,709	−53	−3.0	3,875	2,835	−1,040	−26.8
150,000	45,200	3,524	3,132	−392	−11.1	7,899	5,849	−2,050	−26.0
200,000	60,200	5,425	4,539	−886	−16.3	12,387	10,245	−2,142	−17.3
300,000	90,300	10,800	9,806	−994	−9.2	23,535	19,119	−4,416	−18.8
500,000	150,400	24,401	21,050	−3,351	−13.7	47,074	38,494	−8,580	−18.2

[a] Assumes a one-earner family of four.

the homeowner. All tax calculations are based on the minimum incomes required to purchase such homes assuming a 10 percent mortgage interest rate, a 20 percent down payment and industry-wide lending criteria.

Note that in general the percentage increase in after-tax cost rises as income rises, due to the fact that the tax rate schedule under the Tax Reform Act of 1986 is considerably less progressive. However, there are some income ranges, such as around $60,000, where this general rule is violated because the percentage reduction in marginal tax rates suddenly declines and then increases again as one moves up the income scale. It is also interesting to note that in the low- and moderate-income ranges, $15,000 and $22,600, marginal tax rates actually increase. In those cases the increase in the after-tax cost of homeownership is due entirely to the increase in the standard deduction.

Impact on federal tax liability

Because the demand for owner-occupied housing is not totally insensitive to changes in its price, these increases in after-tax cost are likely to reduce the demand for housing, causing the value of the existing stock of homes to decline. However, in order to estimate this potential decline in value, it is necessary also to determine the impact of tax reform on overall federal tax liability, because a reduced tax burden could offset somewhat the increase in after-tax homeownership costs.

Table 4 presents estimates of the likely impact of the Tax Reform Act of 1986 on the federal tax liability of homeowners with adjusted gross incomes equal to the minimum incomes required to purchase such homes. These tax calculations assume a family of four filing a joint return. All non-housing itemized deductions are averages for itemizers at the corresponding income levels, while the homeownership deductions are typical of recent homebuyers. This analysis reveals that while it is true that aggregate personal taxes are reduced by tax reform, it is not true that every individual taxpayer would realize a significant decline in federal tax liability. Indeed, in general the tax liability of non-itemizing taxpayers would decline significantly, while the tax liability of individuals who do itemize (particularly middle-income homeowners) is very likely to remain essentially unchanged.

Net impact of tax reform

With the after-tax cost of owning one's home increased significantly while federal tax liability is either essentially unchanged or reduced by much less than the increase in the cost of homeownership, the financial situation of recent and prospective homeowners is worsened by tax reform. As shown in Table 5, the after-tax cost of homeownership would absorb 33.4 percent of disposable income under the Tax Reform Act of 1986 compared to 30.0 percent under the old law, assuming the cost of the home remains unchanged. This is roughly the equivalent of a 1.6 percentage point increase in mortgage interest rates. Table 6 presents this same calculation for all of the income levels analyzed in this report, confirming that at most income levels, homeowners turn out to be net losers under tax reform. The data also suggest that households purchasing homes in the $75,000 to $150,000 range, which represents about half of all homes currently being sold, would fare the worst in relative terms.

Impact on home values

Owner-occupied homes are income producing assets, the value of which is influenced by the implicit income stream they provide, net of carrying costs and taxes. An increase in the after-tax cost of owning a home, whether due to an increase in carrying costs, such as an increase in mortgage interest rates, or due to a change in tax law, reduces this net income stream and so reduces the value of such assets to all potential buyers. Table 7 presents estimates of the potential impact on home values, assuming that home values adjust so that the annual after-tax cost of homeownership remains a constant proportion of disposable income. Estimates are provided assuming that mortgage rates remain unchanged and assuming that tax reform leads to a 100 basis point or 1 percentage point decline in mort-

TABLE 5

Impact of the Tax Reform Act of 1986 on a Homeowner's Disposable Income[a]

	1986 Tax Law	Tax Reform Act of 1986	Change
Adjusted Gross Income	$30,100	$30,100	$ —
Federal Tax Liability	$ 1,762	$ 1,709	$ −53
Disposable Income	$28,338	$28,391	$ +53
After-tax Homeownership Costs	$ 8,515	$ 9,492	$ +977
Percent of Disposable Income	30.0%	33.4%	—
Non-housing Disposable Income	$19,823	$18,899	$ −924

[a]Based on the case of a $100,000 home, which would require a minimum income of $30,100 to purchase, assuming a 20 percent down payment and a 10 percent mortgage interest rate.

TABLE 6

Net Impact of Changes in After-tax Homeownership Costs and Federal Tax Liability on Homeowner's Non-Housing Disposable Income

Home Price	Corresponding Income	Non-Housing Disposable Income: 1986 Tax Law	Non-Housing Disposable Income: Tax Reform Act of 1986	Change $	Change %
$ 50,000	$ 15,000	$ 9,981	$ 9,956	$ −25	−0.3%
75,000	22,600	14,911	14,309	−602	−4.0
100,000	30,100	19,823	18,899	−924	−4.7
150,000	45,200	30,100	28,840	−1,260	−4.2
200,000	60,200	40,467	40,155	−312	−0.8
300,000	90,300	60,334	57,916	−2,418	−4.0
500,000	150,440	95,584	93,673	−1,911	−2.0

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gage interest rates.

Barring a decline in mortgage interest rates, home values are likely to fall across the board as a result of the Tax Reform Act of 1986. In general, the relative potential decline in home values rises as current home value increases, although there are some ranges of home prices where this general rule is violated such as with the increase in after-tax cost that has been discussed. In the $75,000 to $150,000 price range, which represents the bulk of all single-family home sales, prices would likely fall 9 to 12 percent. Somewhat greater percentage declines—12 to 14 percent—would likely occur for homes currently valued in excess of $200,000.

At this time, the jury is still out on the issue on whether or not tax reform will induce a general decline in interest rates. Nearly all researchers on this issue have concluded that tax reform is likely to lead to a decline in aggregate investment, which by itself would reduce interest rates. A decline of about 100 basis points in long-term rates has been estimated as the likely magnitude of decline by at least two sources. However, other researchers have concluded that interest rates are not likely to decline because, while aggregate investment demand is reduced, so is the aggregate supply of private savings, particularly business savings in the form of depreciation allowances and tax credits.[4] However, should it occur, a 1 percentage point decline in mortgage interest rates would largely offset the increased tax burden on owner-occupied homes. In this case only modest declines in value in the upper home price range would be likely. In the middle price range essentially no change in value would be likely, while the possibility exists for some modest price increases in the lower and moderate price range. However, it should be emphasized that the increase in tax burden on owner-occupied homes is definite, whereas the potential decline in interest rates is conjectural.

Several points with regard to these potential declines in home values should be noted. First, to the extent that they do occur, such value adjustments are likely to be largely imperceptible. Home prices are rising about 6 percent to 8 percent a year on a nationwide average basis. A downward value adjustment would probably take the form of a somewhat slower rate of appreciation during the course of a few years than otherwise would be the case. Only in depressed market areas where home values have been flat or already declining is tax reform likely to induce an absolute decline in home values.

Second, contrary to what some advocates of tax reform have asserted, a decline of home values due to these changes in tax law would not benefit first-time buyers or current homeowners who would like to upgrade their housing.[5] For example, under current law the annual after-tax cost of a $100,000 home is about $8,500 or about $710 per month. Under the Tax Reform Act of 1986, that after-tax cost would rise to about $9,500, or $790 per month. This increase in after-tax cost is likely to prompt a decline in value of about 10.8 percent or about $10,800, assuming mortgage rates are unchanged. This decline in value would cause the after-tax cost to fall back to about $710 per month. The

TABLE 7

Potential Impact on Home Values Due to Tax Reform

	Tax Reform Act of 1986			
Home Price	Mortgage Rates Unchanged		Mortgage Rates Decline by 100 Basis Points	
	$	%		
$ 50,000	$ −2,874	−5.7%	+2,019	+4.0%
75,000	−6,649	−8.9	+450	+0.6
100,000	−10,795	−10.8	−1,533	−1.5
150,000	−17,916	−11.9	−4,195	−2.8
200,000	−12,778	−6.4	+6,660	+3.3
300,000	−42,240	−14.1	−15,475	−5.2
500,000	−61,663	−12.3	−16,145	−3.2

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point is that, regardless of whether the home costs $100,000 under the old law or $89,200 under the new tax laws, it is still going to cost the homebuyer $710 per month after-tax to own the home.

Finally, several commentators have expressed doubts about the increased tax burden on owner-occupied housing resulting in a decline in value. Those doubts are based not on the expectation of declining interest rates but on what can be referred to as the "last tax shelter" argument. It is argued that because nearly all other tax shelters have been closed by this legislation, the demand for owner-occupied housing will actually increase, due to the fact that mortgage interest and property taxes remain deductible. Further, because consumer interest will no longer be deductible, the demand for owner-occupied housing will increase. People will use the equity in their home to fund purchases of other goods, such as automobiles, so that interest will remain deductible. (In order for this interest to remain deductible for expenditures for things other than medical or education expenses, total mortgage debt is limited to the original purchase price of the home plus improvements.)

Upon closer examination, however, these arguments are not very compelling. To begin with, for most households, homeownership has always been both the primary "tax shelter" and the primary vehicle for accumulating wealth. Tax return data confirm that only a very small fraction of mostly high income households have ever invested in the types of tax shelters, such as real estate or equipment leasing limited partnerships, that this legislation curtails. Other sources of information on households' assets and liabilities, such as the 1983 Survey of Consumer Finances, indicate that for the bulk of households the equity in the home they own has traditionally been their primary source of net worth and that this wealth has been used to fund major expenditures such as a college education. Thus, it is doubtful that such considerations behind the demand for homeownership will be much intensified by tax reform.

It is generally recognized that the Tax Reform Act of 1986 significantly increases the tax burden on so-called income producing real estate such as

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office buildings and shopping centers. This increased tax burden is expected to reduce the value of existing income properties and reduce the level of investment in new properties. Due to the fact that under tax reform mortgage interest and property taxes remain deductible for homeowners, it is not generally recognized that the tax burden on owner-occupied homes is also increased due to a significant decline in the value of these homeownership deductions. Consequently, a similar type of market reaction to this increase in tax burden can be expected. Interestingly, however, the proportion of households who own the home they live in, the homeownership rate, may actually increase as a result of tax reform even though the aggregate amount of housing, whether renter- or owner-occupied, that households demand is likely to decline. The reason for this is that while the after-tax cost of owning a home is expected to increase, the cost of renting is expected to increase even more. Thus, many households, particularly those in the lower and moderate income ranges where the homeownership rate is relatively low, are likely to react to this increase in the relative price of renting by opting for homeownership.

These estimates of potential decline in home value implicitly assume unitary price and income elasticities of demand for owner-occuped housing. Other researchers have used different elasticities and as a result have derived different estimates of the impact of tax reform on home values. □

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[1] See Peach, Richard W., "The Impacts of Tax Reform on Commercial and Rental Residential Real Estate," mimeo.

[2] Source: Advisory Commission on Intergovernmental Relations.

[3] Actual tax savings is likely to be somewhat less. While the last (marginal) dollar of homeownership deductions would be evaluated at a 25 percent marginal rate, the preceding dollars (intra-marginal) would be evaluated at lower marginal rates due to the progressive marginal tax rate structure.

[4] Some general equilibrium analyses have suggested that tax reform, by depressing aggregate investment demand, may cause interest rates to decline. See for example Hendershott, Patric H., "Tax Reform and the Slope of the Playing Field," in *Taxes and Capital Formation*, edited by Martin Feldstein, National Bureau of Economic Research, Inc., Prepublication Report; and Prakken, Joel L., Laurence H. Meyer, and Chris P. Varvares, "The Senate Finance Committee Proposal for Tax Reform, A Macroeconomic Analysis," Center for the Study of American Business, May 23, 1986. Both of these studies suggest that the Senate Finance Committee proposal, which is very close to the final bill, would reduce interest rates about 1 full percentage point. However, it should be noted that not all analysts have concluded that tax reform of the House and Senate Finance Committee proposals type would cause interest rates to decline. For example, see Brinner, Roger E., "The Economic Consequences of Tax Reform as Proposed by the House of Representatives," Data Resources, Inc., January 1986.

[5] See for example, Michael Kinsley, "Viewpoint," Wall Street Journal, June 5, 1986.

[6] Source: 1983 Survey of Consumer Finances, Board of Governors of the Federal Reserve System.

What Is Going Down At HUD?

The proposed tax simplification bill, now law, is universally newsworthy. And why not? It offers apparent simplicity, would put cash in the pockets of almost all classes of taxpayers, purportedly eliminates loopholes, shifts more of the income burden to corporations, and is "revenue neutral," so say the economists. But recall that people who laugh at gypsy fortune tellers actually take economists seriously.

One of the bill's cornerstones is the rapid elimination of the passback of tax losses on real estate limited partnerships. This radical surgery is being performed without distinction between housing for the well-to-do and those of modest means notwithstanding that tax losses have historically been the economic grist for the production of housing for families of low income. Further, the bill breaks new ground by rapidly phasing out the use of these tax losses, even for low income housing partnerships *already in existence*, which are almost totally tax-loss driven and to which the government is a contractual party. The relevant department of the government is the United States Department of Housing and Urban Development (HUD) which has, for years, implicitly and explicitly promoted tax shelters through its legislation as an instrument of national policy as a means of providing shelter for families who could not afford to pay market level rents. The effect of this action will be devastating on this segment of the housing market.

Does this element of the tax bill represent a non-recurring economy measure, or is it part of a continuum reflecting a larger long-term policy?

Programs and funding

At a programmatic level, first take a look at what has happened during the short space of the last seven years since the current administration took over. There are a couple of punch line statistics which provide telltale clues:

- Without a lot of fanfare—because renters of low income housing do not represent a particularly strong and organized constituency—the number of assisted housing units constructed annually in the United States has dropped from an average level of approximately 250,000 units a year under Presidents Nixon, Ford and Carter to a current level of about *one-fourth* that size;
- The federal budget for HUD has plummeted from 35.7 billion dollars for fiscal year 1980 to a proposed 5.5 billion for fiscal year 1987 (an 85 percent reduction).

The aforementioned statistics do not suggest a mere fat-trimming; rather, they indicate something more in the nature of a program dismantling. Take, for example, HUD's single largest program for housing low income families, entitled Section 8. This program provides gap payments to developer/sponsors for the difference between the actual cost of operating a rental project and approximately 30 percent of the tenant's income. It is the mainstay of the department, creating newly constructed and rehabilitated rental units. (See Example 1)

Section 8 production for fiscal year 1986 will be virtually nil.

But what about HUD's other housing programs? The effective 221(d)(3) below-market interest (3 percent) rental program has been canceled. The Section 236 low interest (1 percent) rental program—HUD's second largest—has also been eliminated. Even the subsidized condominium program (Section 235) was scrubbed in 1980 notwithstanding the benefits of giving moderate income families an opportunity for first-time homeownership.

Net loss

A compounding factor should be mentioned. Because of expiring Section 8 subsidy contracts and early mortgage payments, the current nationwide inventory of 1.9 million units will decrease between 200,000-900,000 units during the next nine years. Given the virtual elimination of new housing production, the affordable housing inventory in America will likely experience a net loss between now and 1995.

HUD was created after World War II with a number of purposes—principal among which was to produce housing for low and moderate income families in America. Quietly but surely, the administration has relegated HUD to be a caretaker agency without production tools. Recent statistics indicate that the homeless are 36-38 years of age on average, 20 percent female, with 40 percent having some education beyond high school. The principal cause of the dramatic rise in the homeless is the absence of homes.

Most low and moderate income housing produced in America in the last 20 years has been through for-profit mortgagors in the form of lim-